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INTERNAL REVENUE SERVICE

Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season

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Supplementary Notes

Abstract
We are pleased to participate in the Subcommittees inquiry into the fiscal year 2003 budget request for the Internal Revenue Service (IRS) and the 2002 tax filing season. As you requested, our statement assesses the support for various aspects of IRSs budget request, including the linkage between resources requested and expected results, and IRSs performance in processing returns and providing assistance to taxpayers during this filing season. Our assessment is based on (I) our review of IRSs fiscal year 2003 budget request and supporting documentation; (2) the preliminary results of our review of the 2002 tax filing season; and (3) past and ongoing reviews of various IRS activities, including those related to information systems and performance measures.1

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Mr. Chairman and Members of the Subcommittee:

We are pleased to participate in the Subcommittee's inquiry into the fiscal year 2003 budget request for the Internal Revenue Service (IRS) and the 2002 tax filing season.

As you requested, our statement assesses the support for various aspects of IRS's budget request, including the linkage between resources requested and expected results, and IRS's performance in processing returns and providing assistance to taxpayers during this filing season.

Our assessment is based on (1) our review of IRS's fiscal year 2003 budget request and supporting documentation; (2) the preliminary results of our review of the 2002 tax filing season; and (3) past and ongoing reviews of various IRS activities, including those related to information systems and performance measures.[1]

IRS is requesting about $10.4 billion for fiscal year 2003, an increase of about $500 million, or about 5 percent, over its appropriated level of about $9.9 billion for fiscal year 2002.[2] The proposed request is expected to fund 101,080 full-time equivalent (FTE) staff years, an increase of 1,179 FTEs over 2002. In addition to the increase of 1,179 FTEs, IRS identified internal savings that it expects will allow 2,287 FTEs to be redirected to higher-priority areas. To identify these savings, IRS used its recently implemented strategic planning, budgeting, and performance management process. This process is designed to reconcile competing priorities and initiatives with the realities of available resources. We commend IRS for using this process to reassess the allocation of resources in its base budget for 2003. With respect to IRS's request, our statement makes the following points:

- IRS's plans for hiring and redirecting staff depend on several assumptions that could be optimistic—a natural result, to some extent, of the fact that budgets are prepared so far in advance of the fiscal year involved. These assumptions include (1) labor and nonlabor savings of 2,287 staff years and $157.5 million identified by IRS operating units

[1]Some of our analysis is based on data provided by IRS that we did not verify. These data generally came from management information systems that we have used in the past to assess IRS operations.

[2]These dollar amounts include funding for the legislative proposal on full costing of retirement and health benefits. Absent that legislation, the fiscal year 2003 budget would be $9.9 billion, an increase of $445 million over fiscal year 2002.

and (2) additional savings of $38.5 million resulting from better business practices that have not yet been identified. Also, IRS may face some unanticipated expenses, such as a larger civilian pay raise than proposed by the administration, that could, if not funded, affect IRS's financial plan for 2003. Unrealized savings or unexpected expenses could lead to cutbacks in planned hiring—cutbacks that historically have hit IRS's enforcement programs the hardest.

- IRS's congressional justification does not always provide an adequate link between the resources being requested and IRS's performance goals. In some respects, such as with telephone service, good links exist. In other areas, however, there are either no performance goals against which Congress can hold IRS accountable or there appear to be inconsistencies between the resources being requested and the expected change in performance or workload. The Subcommittee may want to pursue these issues with IRS.

- Although IRS provided adequate support to justify the $450 million request for its multiyear capital account for business systems modernization, it did not adequately support $1.63 billion of the $1.68 billion requested for its information systems. The $1.63 billion is for the operation and maintenance of existing (legacy) systems. We are recommending to IRS that it prepare its fiscal year 2004 information systems budget request in accordance with the practices of leading private and public sector organizations.

Our testimony on the 2002 filing season presents interim data on IRS's performance in processing returns and helping taxpayers who call IRS or walk into an IRS office. The following two themes predominate:

- So far this filing season, IRS has processed returns smoothly, with one major exception, and seen continued growth in electronic filing. The one exception to smooth processing has been the large number of errors taxpayers are making related to the rate reduction credit. IRS has had to correct millions of returns with errors related to the credit, and taxpayers' calls about the credit have greatly increased the demand on IRS's toll-free assistance lines, likely causing IRS's overall level of telephone service to dip significantly for a few weeks during the filing season. Some of these errors may have been avoided if the instructions for the income tax forms had been clearer.

- IRS's performance measures provide useful information on which both IRS and we rely to assess its success in assisting taxpayers. However, some measures of telephone service are constructed in a way that miss

important aspects of the activity being measured, and plans to begin measuring some important aspects of IRS's walk-in service have been delayed.

IRS's Budget Request for Fiscal Year 2003

If IRS's budget request is approved, IRS will have more than 3,400 staff years that can be assigned to new or existing activities in fiscal year 2003. These include the 1,179 additional staff years requested in the budget and the 2,287 staff years that IRS determined could be redirected elsewhere in the organization due to projected savings from several improvement projects and workload decreases. These 3,400 staff years can make a real impact on IRS's performance if they are targeted to selected areas. However, the availability of these staff years depends on the projected savings being realized and no significant unanticipated expenses. In addition, it is difficult to evaluate the effect that these additional and redirected staff years will have on IRS's operations because the budget is not well-linked to performance goals in some important areas.

With respect to that part of the budget request for information technology, IRS (1) did not adequately support the $1.63 billion requested for operation and maintenance of its information systems but (2) did adequately support its $450 million request for business systems modernization.

IRS's Budget Request Is Based on Several Assumptions

IRS's fiscal year 2003 budget request is based on several assumptions that could prove optimistic. These include (1) labor and nonlabor savings of 2,287 staff years and $157.5 million from various improvement projects and workload decreases that IRS plans to use elsewhere in the organization, and (2) additional savings of $38.5 million resulting from better business practices that have not yet been identified. Also, IRS may face some unanticipated expenses that, if not funded, could cause it to revise its financial plan for fiscal year 2003. In many respects, this kind of uncertainty is the natural result of a process that requires the development of budget estimates many months before the fiscal year in question. No matter the reason, the end result could be unrealized savings or unexpected expenses that, as in the past, lead to cutbacks in planned hiring—cutbacks that historically have hit IRS's enforcement programs the hardest.

Through use of its strategic planning, budgeting, and performance management process, IRS identified a myriad of expected efficiency improvements, technological enhancements, labor-saving initiatives, and workload decreases that it projects will enable it to redirect $157.5 million

in its base budget to higher-priority areas. Examples include (1) saving over $67 million from re-engineering and quality improvement efforts, such as consolidating form printing and distribution operations and updating an antiquated workload selection system to reduce or eliminate the substantial number of tax returns that are ordered but never audited, and (2) reducing the resources used for the innocent spouse program by $13.8 million due to an expected decrease in caseload.

We commend IRS for taking the initiative to reassess the allocation of resources in its base budget. However, the congressional justification submitted by IRS in support of its budget request does not explain how IRS developed the labor and nonlabor savings. IRS provided us with information on the overall method used to develop the savings and explained that, in a change from IRS's previously used top-down process, operating units determined the resource increases and decreases their programs needed. However, IRS did not provide details on how specific savings were computed, such as information on any assumptions used in developing specific estimates.

In response to the secretary of the Treasury's challenge for each Treasury bureau to review all programmatic efforts and reduce or remove those producing little or no value, IRS officials estimated that such a review could save $38.5 million. IRS's congressional justification notes that the secretary considers this review to be a work in progress and expects bureau heads and financial plan managers "to work creatively on mid-course adjustments" until the final quarter of fiscal year 2003. Accordingly, the congressional justification provides no details on how the $38.5 million will be achieved.

Any shortfall in the estimated labor and nonlabor savings or in savings from efforts to reduce or eliminate programs will only be exacerbated if IRS has to absorb unanticipated budget increases. For example, IRS officials estimated that it would cost an additional $69 million if the civilian pay raise included in this budget was increased to achieve parity with the proposed pay raise for the military.[3] In fiscal year 2002, IRS faced unbudgeted cost increases related to rent, pay raises, security, and postage rate increases. As a result, IRS had to delay hiring revenue agents and

[3]The administration proposed a 2.6-percent pay increase for civilian employees in fiscal year 2003, which is the percentage IRS used in developing its budget, and a 4.1-percent pay raise for military personnel.

officers, tax compliance officers, and tax specialists. According to IRS, "the lack of full funding for non-labor inflation over the years has greatly reduced the IRS ability to cover pay raise costs and other legitimate cost increases by reducing non-labor costs, leaving the IRS with the sole alternative of reducing staff." IRS noted that "these budget constraints forced the IRS to reduce 1,364 FTEs in the [fiscal year] 2002 plan." Although we do not have specific evidence of how this FTE reduction affected IRS's operations, IRS data does indicate that the number of revenue agent FTEs in its current financial plan for fiscal year 2002 (11,836) is 691 fewer than the actual revenue agent FTEs in fiscal year 2000 (12,527)—despite funding of an initiative in fiscal years 2001 and 2002 that, among other things, was to increase the number of revenue agent FTEs.

Congressional Justification Not Always Well-Linked to Performance Goals

The Government Performance and Results Act of 1993 requires agencies to establish linkages between resources and results. With this requirement, Congress hoped to focus agencies on achieving better results for the American public. Congress also hoped to gain a better understanding of what is being achieved in relation to what is being spent.

In some respects, IRS's congressional justification has good links between the resources being requested and IRS's performance goals. For example, IRS's budget includes an increase of 213 FTEs and $14.1 million to improve its telephone level of service, and its performance measures show an expected increase in toll-free telephone level of service from 71.5 percent in fiscal year 2002 to 76.3 percent in fiscal year 2003.

However, in other important areas, the congressional justification is not well-linked to performance goals. In some instances, there are no performance goals against which Congress can hold IRS accountable. In other instances, there seem to be inconsistencies between the amount of resources being requested and the expected change in performance or workload.

Missing Performance Goals

A significant example of missing performance goals involves IRS's efforts to address major areas of systematic noncompliance. In February 2002, the commissioner of Internal Revenue identified four such areas: (1) misuse of devices, such as trusts and passthroughs, to hide income; (2) use of complex and abusive corporate tax shelters to reduce taxes improperly; (3) failure to file and pay large accumulations of employment taxes; and (4) erroneous refund claims, which include claims made under the Earned Income Credit (EIC) program. The budget request includes increased

resources for compliance but, except for the EIC program, it is unclear from IRS's congressional justification how many resources IRS intends to devote to each of these problems. And, for none of these areas, including the EIC program, does the congressional justification include performance measures and goals that Congress can use to assess IRS's progress in addressing these major compliance problems.

IRS's congressional justification is clear about the amount of resources IRS plans to devote to EIC compliance efforts because the budget request calls for the continuation of a separate appropriation for that program. If approved, it will be the sixth year of targeted funding for the EIC program. IRS's compliance efforts under this program have prevented the payment of hundreds of millions of dollars of improper EIC claims. However, the most recent IRS information shows that the rate of EIC noncompliance is still very high. According to IRS's report on its analysis of EIC compliance rates on tax year 1999 returns filed in 2000, (1) about one-half of the 18.8 million returns on which taxpayers claimed the EIC involved overclaims and (2) of the estimated $31.3 billion in EIC claims made by taxpayers who filed returns in 2000, between $8.5 billion and $9.9 billion should not have been paid.

Audit coverage is another area where performance goals would help Congress assess IRS's progress. IRS states in its congressional justification that it will increase the resources for stabilizing audit rates by 368 FTEs and $24 million. Although the congressional justification states that audit rates have fallen, the justification does not include any information about current audit rates or what rates IRS expects to achieve in 2003.

Issue for Congressional Oversight

Given the amount of resources that could be involved in dealing with the four major compliance problems cited by the commissioner and increasing overall audit coverage, the Subcommittee may want to ask IRS to provide (1) more specifics on the level of resources it plans to devote to each of these areas and its performance measures and goals for each area and (2) its views on maintaining a separate appropriation for the EIC versus combining in one appropriation those resources with the resources being requested for other compliance work, which could give IRS more flexibility in deciding how best to allocate its resources among all of its compliance needs.

Inconsistencies between Budget Request and Performance Goals

The budget request and performance goals included in the congressional justification are, at times, inconsistent. Some of those inconsistencies might suggest that additional resources beyond those identified by IRS are

available for redirection. Specific examples of inconsistencies include the following:

- A requested increase of 476 staff years and $20.7 million for "increased Offer-in-Compromise cases" is inconsistent with IRS's performance goal for that program, which shows that the number of cases processed is expected to decrease from 185,000 in 2002 to 104,600 in fiscal year 2003. This requested increase also conflicts with our recent evaluation of the program that shows that IRS projected that the number of staff years needed would decrease from 1,818 in fiscal year 2002 to 1,224 in fiscal year 2003.[4] In response to our question about this, IRS officials said that the staff year increase is to replace revenue officers who currently handle the cases so there is not a net increase in staff years for the offer program. This does not help explain why IRS is asking for an increase in resources when the workload is expected to decline and IRS had projected a decreased need for staff in the program.

- According to IRS's budget request, the field and electronic/correspondence exam units will receive about the same number of staff years as the year before, while in terms of dollars, the field exam unit will receive an increase of less than 3 percent and the electronic/correspondence unit will receive an increase of about 7 percent. However, IRS's performance measures show the field exam unit is expected to examine 33 percent more individual returns and almost 35 percent more business returns while the electronic/correspondence unit is expected to increase the number of correspondence examinations by 32 percent. It is not clear from the congressional justification how IRS expects to do so much more work with just a small increase in resources. IRS told us that one reason for the apparent inconsistency is that correspondence audits run on a 2-year cycle, with a high number of case starts in one year and a large number of case closures in the next year.

- IRS' budget request includes an additional 197 staff years and $8.3 million for processing a projected growth in the total number of primary returns filed from about 225.9 million returns in fiscal year 2202 to about 230.0 returns in fiscal year 2003. However, according to IRS's performance measures, that projected growth is the net of an increase of about 7.6 million returns filed electronically and a decrease of about 3.4 million returns filed on paper. That decline in the more

[4] U.S. General Accounting Office, *Tax Administration: IRS Should Evaluate the Changes to its Offer in Compromise Program*, GAO-02-311 (Washington, D.C.: Mar. 15, 2002).

costly to process paper returns would seem to argue against the need for additional processing resources. In response to our question about this, IRS acknowledged that the number of paper returns was expected to decline but said, nonetheless, that its computation of the number of additional FTEs needed was "based on an estimate of direct hours needed to process expected paper returns."

Issue for Congressional Oversight

Because the congressional justification provides inadequate information to explain the apparent inconsistencies discussed in the preceding section and because, in some respects, those inconsistencies suggest that additional resources might be available for redirection to other purposes, the Subcommittee may want to ask IRS for additional information in support of those parts of its budget request.

Justification for Information Technology Budget Request Needs Improvement

IRS is requesting $2.13 billion and 7,449 staff years in information technology (IT) resources for fiscal year 2003. This includes (1) $450 million for the agency's multiyear capital account that funds contractor costs for the Business Systems Modernization (BSM) Program, which is adequately justified, and (2) $1.68 billion and 7,449 staff years for information systems, of which $1.63 billion for operations and maintenance is not adequately justified. With respect to the $1.63 billion request for operations and maintenance, IRS was unable to provide sufficient support for us to identify possible budget reductions.

Fiscal Year 2003 BSM Request Is Adequately Justified

Key provisions of the Clinger-Cohen Act, the Government Performance and Results Act, and Office of Management and Budget (OMB) guidance on budget preparation and submission (e.g., Circular No. A-11) require that, before requesting multiyear funding for capital asset acquisitions, agencies develop sufficient justification for these investments. This justification should reasonably demonstrate how proposed investments support agency mission operations and provide positive business value in terms of expected costs, benefits, and risks.

Since the BSM appropriation was established in fiscal year 1998, we have consistently reported that IRS has not developed adequate justification for its budget requests, and we have proposed that Congress consider

reducing them.[5] During this same time, we have repeatedly recommended[6] that IRS put in place an enterprise architecture (modernization blueprint) to guide and constrain its business system investments.[7] Use of such a blueprint is a practice of leading public and private sector organizations. Simply stated, this architecture provides a high-level roadmap for business and technological change from which agencies can logically and justifiably derive their budget requests and capital investment plans. In response, IRS has developed various versions of an enterprise architecture, which we have continued to review and make recommendations for improvement in. IRS recently approved a new version of this architecture (version 2.0), which, based on a briefing to us and others, appears to provide robust descriptions of IRS's current and target business and technology environments. IRS has also drafted, and executive management is reviewing, the associated high-level transition plan that identifies and conceptually justifies needed investments to guide the agency's transition over many years from its current to its target architectural state.

IRS's $450 million request is based on its enterprise architecture as well as related life cycle management and investment management process disciplines for its ongoing project investments. As such, this request is grounded in analyses that meet the statutory and regulatory requirements for requesting multiyear capital investment funding.

Pursuant to statute,[8] funds from the BSM account are not available for obligation until IRS submits to the congressional appropriations

[5]U.S. General Accounting Office, *Tax Administration: IRS' 2000 Tax Filing Season and Fiscal Year 2001 Budget Request*, GAO/T-GGD/AIMD-00-133 (Washington, D.C.: Mar. 28, 2000); *Tax Administration: IRS' Fiscal Year 2000 Budget Request and 1999 Tax Filing Season*, GAO/T-GGD/AIMD-99-140 (Washington, D.C.: Apr. 13, 1999); *Tax Administration: IRS' Fiscal Year 1999 Budget Request and Fiscal Year 1998 Filing Season*, GAO/T-GGD/AIMD-98-114 (Washington, D.C.: Mar. 31, 1998); *Tax Administration: IRS' Fiscal Year 1997 Spending, 1997 Filing Season, and Fiscal Year 1998 Budget Request*, GAO/T-GGD/AIMD-97-66 (Washington, D.C.: Mar. 18, 1997).

[6]See, for example, GAO/T-GGD/AIMD-97-66; U.S. General Accounting Office, *Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems*, GAO/AIMD/GGD-98-54 (Washington, D.C.: Feb. 24, 1998); and GAO/T-GGD/AIMD-00-133.

[7]An enterprise architecture provides an institutional "blueprint" for defining how an organization operates today (baseline environment), in both business and technological terms, and how it wants to operate in the future (target environment). It also includes a sequencing plan that provides a roadmap for transitioning between these environments.

[8] The Treasury and General Government Appropriations Act of 2002 (P.L. 107-67).

committees for approval an expenditure plan that meets certain conditions.[9] In November 2001, IRS submitted its fifth expenditure plan seeking approval to obligate the $391 million remaining in the BSM account at that time. In briefings to the relevant appropriations subcommittees and IRS, we reported our concerns about the escalating risk that IRS will be unable to deliver promised BSM system capabilities on time and within budget due to the number and complexity of ongoing and planned systems acquisition projects and the continued lack of certain key modernization management controls and capabilities.

In approving the expenditure plan, the appropriations subcommittees directed IRS to reconsider the scope and pace specified in the November 2001 expenditure plan to ensure that the number and complexity of modernization projects underway is commensurate with IRS's management capacity and fully establish and implement all process controls needed to effectively manage the modernization effort prior to the submission of IRS's next expenditure plan.

In response to these and other concerns raised by the appropriations committees and us, IRS has committed to aligning the pace of the BSM program with the maturity of the organization's management controls and management capacity and is currently conducting a reassessment of the projects it plans to deploy during fiscal year 2002. In addition, IRS has taken appropriate steps toward implementing missing management controls.

IRS's Information Systems Request for Operations and Maintenance Is Not Adequately Justified

Leading private and public sector organizations have taken a project or system-centric approach to managing not only new investments but also operations and maintenance of existing systems. As such, these organizations

- identify operations and maintenance projects and systems for inclusion in budget requests;
- assess these projects or systems on the basis of expected costs, benefits, and risks to the organization;
- analyze these projects as a portfolio of competing funding options; and

[9] IRS's BSM expenditure plans are required to (1) meet OMB capital planning and investment control review requirements; (2) comply with IRS's enterprise architecture; (3) conform with IRS's enterprise life cycle methodology; (4) be approved by IRS, Treasury, and OMB; (5) be reviewed by us; and (6) comply with the acquisition rules, requirements, guidelines, and systems acquisition management practices of the federal government.

- use this information to develop and support budget requests.

This focus on projects, their outcomes, and risks as the basic elements of analysis and decisionmaking is incorporated in the IT investment management approach recommended by OMB and us.[10] By using these proven investment management approaches for budget formulation, agencies have a systematic method, based on risk and return on investment, to justify what are typically very substantial operations and maintenance budget requests. These approaches also provide a way to hold IT managers accountable for operations and maintenance spending and the ongoing efficiency and efficacy of existing systems.

IRS did not develop its information systems request in accordance with these best practices of leading organizations. In particular, the largest elements of IRS's budget request are not projects or systems. Rather, they are requests for staffing levels or other services. For example, IRS is requesting $240 million for staff and equipment supporting operations and maintenance of desktop computers agencywide, as well as $111 million for staff and equipment supporting its major computing centers' operations. Further, it is requesting $266 million for telecommunications services contracts. Taken together, these three initiatives constitute about 38 percent of the total $1.63 billion being requested for operations and maintenance, but the budget request gives no indication regarding how these initiatives are allocated to systems. In addition, in developing these requests, IRS did not identify and assess the relative costs, benefits, and risks of specific projects or systems in these areas. Instead, according to IRS officials, they simply took what was spent last year in the categories and added the money to fund cost-of-living and salary increases.

IRS officials responsible for developing the IT operations and maintenance budget attributed the differences between IRS practices and those followed by leading organizations to the lack of an adequate cost accounting system, cultural resistance to change, and a previous lack of management priority. To better justify future budget requests, these officials said that they have assessed the strengths and weaknesses of IRS's budgeting and investment management processes against our IT investment management framework[11] and found significant weaknesses in

[10] See, for example, U.S. General Accounting Office, *Information Technology Investment Management: A Framework for Assessing and Improving Process Maturity*, Exposure Draft, GAO/AIMD-10.1.23 (Washington, D.C., May 2000, Version 1).

[11] GAO/AIMD-10.1.23.

15 critical areas. To address the weaknesses, IRS is currently developing capital planning guidance based on our IT investment management framework. This guidance is to be issued by late summer 2002, but a schedule for implementing it has yet to be determined. In addition, IRS has adopted and is in the process of implementing a cost model that is to enable it to account for the full costs of operations and maintenance projects and determine how effectively IRS projects are achieving program goals and mission needs. IRS plans to have the cost model in place and operational by June 30 of this year so that it can validate its fiscal year 2003 information systems appropriation request and begin using it to develop the fiscal year 2004 request.

The key to making these plans reality is overcoming the very reasons that have allowed this budgetary formulation and justification weakness to continue unabated—accounting system limitations, cultural resistance, and low management priority. Although IRS has initiated actions to address these weaknesses, we are concerned whether they will be implemented in time to have meaningful impact on formulation of the fiscal year 2004 budget request. For example, IRS has not yet developed a plan and schedule for implementing its IT capital planning guidance. In addition, IRS officials told us that they are already beginning the process to develop the fiscal year 2004 budget. Consequently, until IRS overcomes its obstacles, its future information systems appropriation requests, like its fiscal year 2003 request, will not be adequately justified.

Recommendation for Executive Action

To aid IRS in overcoming the barriers to changing how it develops and justifies its information systems appropriation request, we recommend to the commissioner of internal revenue that IRS prepare its fiscal year 2004 information systems budget request in accordance with leading organizations' best practices.

Interim Results of IRS's 2002 Filing Season Show Impact of the Rate Reduction Credit

So far this filing season, IRS has processed returns smoothly with one major exception, seen continued growth in electronic filing, and achieved some improvements in telephone service. The one exception to smooth processing has been the large number of errors taxpayers are making related to the rate reduction credit. Although the errors have not affected the timeliness of processing, they have resulted in a significant error correction workload for IRS, the rejection of some electronically filed returns, and an increased demand for telephone assistance that, according to agency officials, is affecting taxpayers' access to IRS's telephone assistors. One issue that continues to affect IRS's ability to assess its filing season performance is missing performance measures. While IRS has

measures that provide useful information on some aspects of its service and is making efforts to improve its performance measures, some measures of telephone service are constructed in a way that misses important aspects of the activity being measured and IRS has delayed implementation of some accuracy measures for services provided at walk-in offices.

Errors Related to the Rate Reduction Credit Have Adversely Affected an Otherwise Smooth Processing Season

This filing season, IRS experienced very few of the kinds of processing problems, such as those caused by computer programming errors, that it has often experienced at the beginning of a filing season, and the number of returns filed electronically continues to grow. The one major negative in this otherwise positive picture has been the significant number of returns IRS has received with errors related to the rate reduction credit.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. No. 107-16) directed the secretary of the Treasury to issue advance tax refunds to eligible taxpayers. Accordingly millions of taxpayers received checks of up to $600 between July and December 2001. Taxpayers who did not receive an advance refund as part of that process or who received less than the maximum allowed by law may have been entitled to a rate reduction credit when filing their tax year 2001 returns in 2002. Accordingly, IRS added a line to the individual income tax forms for eligible taxpayers to enter a credit amount and provided a worksheet for taxpayers to use in determining if they were eligible. So far, during the 2002 filing season, the rate reduction credit has led to millions of tax returns with errors.

The result has been significant error-correction workloads for IRS and a large increase in the number of error notices sent to taxpayers. In retrospect, at least some of these errors might have been avoided if IRS had taken certain steps to better help taxpayers deal with this new tax return line item. One of the steps IRS took to deal with the large number of errors related to rate reduction credit was to reject certain electronic submissions involving rate reduction credit errors. Even so, electronic filing has continued to grow—although not at a rate that would allow IRS to meet its long-term goal.

Millions of Returns Filed with Errors Related to the Rate Reduction Credit

As table 1 shows, of the approximate 46 million returns that IRS had processed as of March 15, 2002, about 4.7 million, or 10 percent, had errors made by taxpayers or their return preparers—more than twice the error rate at the same time last year but roughly comparable to the error rate

IRS expected. Of the approximate 4.7 million returns with errors, about two-thirds, or 3.1 million, had errors related to the rate reduction credit.

Table 1: Processed Returns with Rate Reduction Credit Errors Made by Taxpayers or Return Preparers as of March 15, 2002

Returns prepared by	Number of returns processed	Number of returns with errors	Percentage of returns with errors	Number of returns with rate reduction credit errors	Percentage of returns with rate reduction credit errors	Rate reduction credit errors as a percent of returns with errors
Taxpayers	17,778,234	2,638,705	14.8	1,506,932	8.5	57.1
Tax return preparers	28,172,854	2,042,626	7.3	1,613,689	5.7	79.0
Total	**45,951,088**	**4,681,331**	**10.2**	**3,120,621**	**6.8**	**66.7**

Note: Because some returns could contain errors related to the rate reduction credit as well as other errors, a decrease in the number of rate reduction errors would not necessarily equate to a like decrease in the overall number of returns with errors.

Source: GAO-generated from IRS data.

Taxpayers and return preparers are making various types of errors related to the rate reduction credit. Many taxpayers who did not receive an advance of their rate reduction credit in 2001 and thus should be claiming the credit on this year's return, are not. Other taxpayers are recording the amount of the credit they received in 2001 on the rate reduction credit line of this year's return instead of recording zero. And other taxpayers, who are entitled to a credit and are claiming one, are incorrectly computing the amount to which they are entitled.

Once IRS recognized that taxpayers and preparers were having problems with the rate reduction credit, it took immediate action in an attempt to minimize future errors and avoid refund delays. IRS posted information to its Web site, began a public awareness campaign that included news releases to media outlets, and provided clarifying information to preparers who file returns electronically. Despite IRS's efforts, the rate at which taxpayers and return preparers are making errors related to the rate reduction credit has remained relatively constant.

Because IRS anticipated an increase in errors this year and because IRS has been able to correct the rate reduction errors relatively quickly, we are not aware of any adverse impact on IRS's ability to process returns and refunds in a timely manner as a result of the increased error-correction workload. IRS is treating these errors as "math errors"; that is, it corrects the mistake and either adjusts the taxpayer's refund or notifies the taxpayer of additional tax owed. However, it remains to be seen what

happens around April 15, when the largest volume of paper returns are filed. Even if IRS is able to effectively correct the large volumes of erroneous returns throughout the filing season, there are costs involved, including the cost of generating and mailing several million error notices to affected taxpayers and the costs of the resources IRS had to devote to working the increased error-correction workload.

IRS May Have Been Able to Prevent Some Rate Reduction Credit Errors

Although IRS took several steps after the filing season began in response to the large number of rate reduction credit errors, we believe, in retrospect, that some of those errors might have been prevented if the instructions for Forms 1040, 1040A, and 1040EZ had been more clear. For example, IRS did not highlight the rate reduction credit or the new line on the tax form related to the rate reduction credit on the cover page of the instructions, where IRS alerts taxpayers to changes from the prior year. Instead, IRS highlighted the fact that tax rates were reduced. Only if taxpayers read the paragraph under the highlighted caption “Tax Rates Reduced” would they see mention of the credit.

The instructions for Forms 1040, 1040A, and 1040EZ might have also been clearer if IRS had included some information that was included on its Web site. In that regard, the instructions indicate that if a taxpayer received—before any offset—an amount equal to either $600, $500, or $300 based on his or her filing status, the taxpayer is not entitled to a rate reduction credit. There is no further explanation of the term “before any offset”—a term that may be unclear to many taxpayers. However, IRS’s Web site spells out more clearly what is meant by this term, explaining that if taxpayers had their advance payment offset to pay back taxes, other government debts, or past due child support, they cannot claim the rate reduction credit for the amount that was offset. Although the Web site includes this more descriptive information, there is no guarantee that a given taxpayer either has access to or will use the Web site. In retrospect, including the same explanation of “before any offset” in the instructions would have made the instructions clearer.

Use of Electronic Filing Continues to Grow, but not at a Pace to Achieve IRS’s Long-Range Goal

Another step IRS took that has reduced its error-correction workload due to the rate reduction credit was to begin rejecting electronic submissions that involved certain types of errors related to the credit. By doing so, IRS required the taxpayer or return preparer to correct the error before IRS would accept the electronic return. This is consistent with IRS’s traditional practice of rejecting electronic submissions that contain other errors, such as incorrect Social Security numbers. IRS began rejecting electronic submissions with errors involving the rate reduction credit around the

beginning of February. As of March 24, 2002, IRS had rejected about 226,000 such submissions.

We do not know whether these rejected submissions caused potential electronic filers to file instead on paper. However, as shown in table 2, the number of individual income tax returns filed electronically as of March 29, 2002, has grown by 14.0 percent—an increase over the rate of growth at the same time last year. While this kind of increase is not insignificant, IRS will need larger increases in the future if it is to achieve its goal of having 80 percent of all individual income tax returns filed electronically by 2007.[12]

Table 2: Individual Income Tax Returns Received by IRS (Number of returns in millions)

Filing type	1/1/00 to 3/31/00	1/1/01 to 3/30/01	Percentage change: 2000 to 2001	1/1/02 to 3/29/02	Percentage change: 2001 to 2002
Paper	40.9	37.2	-9.1	35.5	-4.7
Electronic					
Traditional[a]	21.4	24.0	12.3	26.9	12.1
On-line[b]	3.5	4.8	36.4	6.7	39.4
TeleFile[c]	4.4	3.7	-14.7	3.5	-6.6
Subtotal	29.3	32.6	11.2	37.1	14.0
Total	**70.2**	**69.7**	**-0.6**	**72.6**	**4.1**

Note: Subtotals, totals, and percentages may not compute due to rounding.

[a]Traditional electronic filing involves the transmission of returns over communication lines through a third party, such as a tax return preparer, to an IRS processing center.

[b]On-line returns are prepared and transmitted by the taxpayer through an on-line intermediary using a personal computer and commercial software.

[c]Under TeleFile, certain taxpayers who are eligible to file a Form 1040EZ are allowed to file using a toll-free number on touch-tone telephones.

Source: IRS data.

[12]As noted in our report on the 2001 filing season, assuming annual growth rates of 13.7 percent for individual income tax returns filed electronically and 1.85 percent for the total number of individual income tax returns filed (the growth rates experienced in 2001), about 60 percent of all individual income tax returns will be filed electronically in 2007. See U.S. General Accounting Office, *Tax Administration: Assessment of IRS' 2001 Tax Filing Season*, GAO-02-144 (Washington, D.C.: Dec. 21, 2001).

To encourage more electronic filing in 2002, IRS, among other things

- mailed letters to about 250,000 tax professionals, asking those who had been filing electronically to continue supporting the program and encouraging others to file electronically;
- mailed about 23 million postcards to certain taxpayers, such as those who had received TeleFile packages in the past 2 years but did not file their tax returns via TeleFile, alerting them to the benefits of electronic filing; and
- made changes to one program that enabled electronic filers to sign their returns using a personal identification number (PIN) and reinstituted another PIN-based signature program.[13]

IRS also redirected its marketing efforts to encourage persons who have been preparing tax returns on a computer but filing on paper to file electronically. Considering that about 40 million computer-prepared returns were filed on paper in 2001, conversion of those returns to electronic filings could go a long way toward helping IRS achieve its 80-percent goal. In our report on the 2001 filing season, we recommended that IRS directly survey tax professionals and taxpayers who file computer-prepared returns on paper to get more specific information on why they are not filing electronically.[14] We have been told that IRS will be undertaking such a survey in the near future.

IRS Has Experienced Some Improvements in Telephone Service, but the Rate Reduction Credit Is Likely Affecting Taxpayers' Access

So far this filing season, taxpayers in the queue for telephone assistance are spending less time waiting to talk with an assistor and are getting accurate answers to their tax law questions more often than last year. At the same time, however, the overall rate at which callers are reaching an assistor is lower because many callers are unable to get into the queue for assistance.

Telephone assistance is a significant part of IRS's work. This fiscal year, IRS expects to answer about 108 million telephone calls, about 72 million to be answered via automated services and about 34 million to be answered by about 10,000 full-and part-time telephone assistors, called customer service representatives. Accordingly, the ease with which

[13] IRS efforts to increase the use of PINs and thus avoid the need for electronic filers to send signature documents to IRS has had a positive effect. As of March 14, 2002, about 17.1 million individual returns were filed using a PIN—about 180 percent more than the 6.1 million filed for the same time period in 2001.

[14] GAO-02-144.

taxpayers reach IRS by telephone and the accuracy of the assistance they receive are important indicators of how well IRS is performing. IRS's performance in providing this service has been a perennial problem, and its struggles to improve service have been a topic at hearings held by this Subcommittee for many years. As we reported in December 2001, IRS has made limited progress toward its long-term goal of providing taxpayers "world-class customer service"—service comparable to the best provided by other organizations.[15]

Some Improvements in Accessibility and Accuracy

In recent years, IRS has made significant strides in developing performance measures to tell how well it is serving taxpayers by telephone. IRS has established a set of measures to focus efforts on enhancing taxpayers' access to accurate assistance. As shown in table 3, some of these measures indicate significant improvements in taxpayer service when compared to the same period last year. For example, during the first 11 weeks of the 2002 filing season,

- taxpayers, on average, waited a minute-and-a-half less to speak to an assistor,
- there was an 18 percentage point improvement in taxpayers reaching assistors in 30 seconds or less, and
- the quality of tax law assistance, which involves following IRS procedures and providing accurate responses, improved about 11 percentage points.

However, there was a 5-point decline in the percentage of callers that attempted to reach an assistor and actually got through and received service (referred to as the customer service representive (CSR) level of service). According to IRS officials, an increased demand for assistance related to the rate reduction credit has been a key factor affecting taxpayer access to assistors. (See appendix I for more detail on the level of access this filing season compared to last and the likely impact of the rate reduction credit.) The increased call volume was not allowed to lengthen the queue. Instead, taxpayers were provided access to automated services, which often results in callers hanging up, or were advised by a recorded message that IRS could not provide assistance.

[15] U.S. General Accounting Office, *IRS Telephone Assistance: Limited Progress and Missed Opportunities to Analyze Performance in the 2001 Filing Season*, GAO-02-212 (Washington, D.C.: Dec. 7, 2001).

Table 3: Telephone Assistance Performance in the First Weeks of the 2001 and 2002 Filing Seasons

Measure[a]	2001	2002
Accessibility measures		
CSR level of service[b]	71%	66%
Assistor response level[c]	39	57
Abandon rate[d]	16	13
Average speed of answer[e]	299 seconds	209 seconds
Accuracy measures		
Tax law quality rate[f]	70% +/- 2%	81% +/- 1%
Accounts quality rate[f]	71+/- 2%	74 +/- 2%
Tax law correct response rate[g]	75 +/- 2%	84 +/- 1%
Accounts correct response rate[g]	87+/- 2%	88 +/- 1%

[a]Accessibility measures are based on actual counts from January 1 through March 16. Accuracy measures are based on representative samples and are estimated at the 90-percent confidence level from January through February.

[b]This measure is intended to show the percentage of callers who wanted to speak to an assistor that got through and received service.

[c]The percentage of callers that waited 30 seconds or less before speaking to an assistor.

[d]The percentage of callers that hung up while waiting to speak to an assistor.

[e]The average number of seconds callers waited before speaking to an assistor.

[f]The percentage of calls in which assistors followed all IRS procedures for the call type and provided correct answers.

[g]The percentage of calls in which assistors provided correct answers for the call type, discounting procedural errors.

Source: IRS data.

IRS Officials Attribute Improvements in Telephone Service to Several IRS Efforts

According to IRS officials, several IRS efforts have contributed to improvements in telephone performance. For example, IRS implemented a strategy to improve tax law accuracy that included hiring and training assistors earlier than in past years and putting them on the telephones in December to help hone their skills before the filing season began. IRS also required assistors to be certified that they successfully completed necessary training and could accurately answer calls in their assigned topics and used its computer-based call routing system to help ensure that assistors answered calls only in those topics for which they had been certified.

Some officials opined that improvements in accessibility may be linked to IRS's efforts to establish new performance measures and goals for the call sites this year. For example, each site has a goal for the total number of calls its assistors are to answer in a fiscal year. IRS officials say the new

measures have led to improved performance by giving the call sites a clearer understanding of what they are expected to achieve and how their performance helps IRS achieve its goals. IRS executives in the Wage and Investment and Small Business/Self-Employed divisions said that they believe that IRS has been successful in getting employees at all levels of the telephone service organizations to understand and accept the measures and contribute to achieving the goals.

IRS officials cited several other service improvement efforts as potentially boosting performance, including initiatives to bring more highly skilled employees on board, increased specialization at the assistor and call site levels, and reduced hours of service to increase the number of assistors available to answer phone calls during the hours when most taxpayers call IRS. We will monitor these and other factors that may have affected IRS's telephone service as we continue to assess the 2002 filing season.

IRS's Performance Measures Provide Useful Information on Some Aspects of Its Telephone Service but Not on Others

Although IRS's telephone performance measures provide useful information on some aspects of service to taxpayers, the measures miss other aspects. For example:

- None of the measures currently reflect how many callers hung up while listening to the menu they hear when calling IRS—although IRS has that data. For example, as of March 16, 2002, according to IRS data, over 7.2 million callers had hung up when listening to the menu this filing season—almost three times greater than the number that hung up last year. IRS officials said it is unclear why more taxpayers were hanging up. However, when IRS streamlined the menu in mid-February, it noted a decline in the hang-up rate, which may indicate that taxpayers were frustrated or confused by the menu.

- Although IRS assists many callers through automated services—almost 18.2 million calls were answered by automation on the three main assistance lines and the TeleTax line as of March 2, 2002—IRS's measures only deal with the service provided by assistors.[16] IRS discontinued measuring the level of service provided through

[16] TeleTax provides automated account information and recorded information on about 150 tax topics.

automation because this year's data are not comparable to 2001.[17]

- Contrary to what its name implies, the CSR level of service measure does not reflect only those calls handled by assistors. Some calls handled through automation are counted as having been answered in computing this measure.[18] Because it includes calls answered through automation, the CSR level of service measure may be overestimating the rate at which assistors are responding to taxpayers.

Because we recognize that it is important to limit the number of performance measures to the vital few, we are not recommending that IRS take any action at this time with respect to the matters discussed above. At your request, Mr. Chairman, we are reviewing IRS's filing season performance measures, including its telephone measures, and plan to issue a report later this year on our results.

IRS Is Measuring Tax Law Accuracy at Its Taxpayer Assistance Centers; Implementation of Two Other Accuracy Measures Has Been Delayed

Taxpayers who visit any one of IRS's 400 plus Taxpayer Assistance Centers (TAC) can make payments, obtain tax forms and publications, get answers to tax law questions, and get help resolving tax account issues and preparing tax returns. In the past, IRS has used its employees to measure the accuracy of tax law assistance provided by its TACs. In fiscal year 2002, IRS began using contract reviewers in lieu of its employees. Although the accuracy rate reported through mid-March 2002 is encouragingly high, the use of different measurement methodologies precludes valid comparison to the low accuracy rates reported by IRS and the Treasury Inspector General for Tax Administration (TIGTA) in 2000 and 2001, respectively. IRS had planned to begin measuring the accuracy of account and return-preparation assistance in January 2002, but those plans have been delayed until June.

Tax Law Accuracy Rates are Encouraging, but Cannot Be Compared to the Low Accuracy Reported in 2000 and 2001

Contract reviewers, posing as taxpayers, reported making 388 random visits to TACs between January 1 and March 15, 2002. During each visit, the reviewers asked two tax law questions from the slate of four questions that IRS developed for use this year. One question and a related scenario

[17] At the beginning of the 2002 filing season, IRS made changes to the TeleTax system that allowed IRS to count abandoned calls, which, as of March 2, 2002, were about 31 percent of total TeleTax calls. Before the 2002 filing season, because IRS could not count abandoned calls, it assumed all calls into TeleTax were served.

[18] There were about 780,000 of these calls during the 2001 filing season.

was developed from each of four tax law categories that most prompted taxpayers to call IRS's toll-free assistance lines in fiscal year 2001.[19] The contract reviewers reported receiving accurate responses for 652 of the 776 questions or 84 percent.[20] Although this could indicate that accuracy is improving compared to the low accuracy rates reported by IRS in 2000 (24 percent) and TIGTA in 2001 (51 percent), the use of different accuracy measurement methods in the last three filing seasons does not afford a valid basis for comparison. Although the results in each of the 3 years were based on visits to TACs by persons posing as taxpayers, there were differences in such things as the questions the persons asked, the number of weeks covered by the reviews, and the number of sites visited and how they were selected.

Implementation of Account- and Return-Preparation Accuracy Measures Has Been Delayed

IRS had planned to begin measuring the accuracy of account- and return-preparation services provided by TACS in January 2002. However, according to field assistance officials, staffing of eight new positions for doing these reviews was initially delayed by an oversight in the announcement process and then by a hiring freeze. Officials now expect to fill the eight positions by June 2002, which, they believe, will still allow time to complete enough quality reviews to establish meaningful fiscal year 2002 baselines for both measures. According to the Director, Field Assistance, the new staff would first complete post-reviews of returns prepared during the filing season. Because most account assistance occurs after the filing season, they would then begin reviewing the accuracy of account assistance provided over the remainder of the year.

[19] Field assistance is using the toll-free database to identify these categories until such time as it has its own database of the tax law categories causing the most questions from TAC customers.

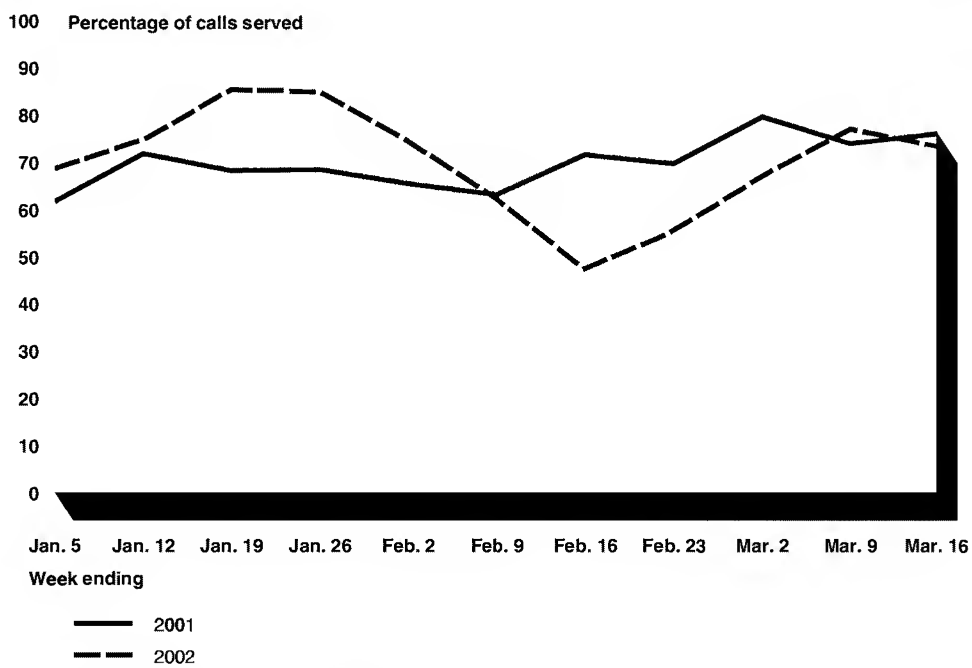
[20] We have not assessed these results or the methodology being followed by the contract reviewers.

Mr. Chairman, that concludes our statement. We would be pleased to respond to any questions that you or other members of the Subcommittee may have at this time.

Appendix I: Increased Demand Related to the Rate Reduction Credit Has Likely Affected Accessibility

As noted earlier, despite some significant improvements in telephone service, the customer service representative (CSR) level of service as of March 16, 2002, was lower than at the same point in time last year. The week-to-week comparisons in figure 1 show that CSR level of service during the first 6 weeks of this filing season was significantly better than or about the same as during the first 6 weeks of the 2001 filing season but was significantly worse during the next 3 weeks. In the following 2 weeks, CSR level of service returned to levels comparable to last year's performance.

Figure 1: CSR Level of Service in the First 11 Weeks of the 2001 and 2002 Filing Seasons



Note: Beginning the week ending March 2, IRS revised its formula for calculating CRS level of service for both 2001 and 2002. Data in the graph prior to March 2 are based on the previous formula. Our analysis of IRS data showed the change had positive but minimal impact on the values, averaging 0.6 percent but never more than 1.89 percent.

Source: IRS data.

According to IRS officials, a key factor that may be negatively affecting telephone accessibility this year is an increase in the demand for assistance, specifically demand related to the rate reduction credit. According to IRS officials, demand was lower than expected in January 2002, which contributed to an increase in level of service. However, as the

filing season progressed, demand for assistance related to the rate reduction credit increased significantly and unexpectedly. IRS officials said that taxpayer access to service began declining in early February as more taxpayers called in response to publicity about the filing problems related to the rate reduction credit and as taxpayers began receiving error notices from IRS. IRS data on the amount of demand for telephone assistance generated by the rate reduction credit is incomplete, and, therefore, the effect on telephone level of service is uncertain.